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**From:****Sent:** Thursday, August 13, 2009 1:51:45 PM**To:****Cc:****Subject:** Accounting for Swaption Hedge of Debt

This responds to your request for advice in connection with Taxpayer's informal refund claim with respect to two fixed-to-floating interest rate swaptions entered into by Taxpayer to hedge its anticipated acquisition of aggregate debt assets. The European style swaptions, which expired worthless in the year acquired, were designed to be exercisable at or about the time Taxpayer expected to acquire section 582(c) debt assets. The term of the underlying swaps, if exercised, would have matched the expected life of the debt. Taxpayer generally documented that it was hedging the impact that interest rate movements and the anticipatorily acquired debt would have on its regulatory capital position, though there is apparently disagreement over whether that risk extended beyond the point that the debt was acquired. Although Taxpayer timely identified the swaptions as hedges, it did not set forth in its books and records a section 1.446-4(d)(1) description of how it would account for the swaptions so as to clearly reflect income in accordance with the hedge timing rules.

Citing section 1.446-3(g)(3) and general option taxation authority (e.g., Rev. Rul. 78-182), Taxpayer claims that it may deduct its loss (the premium paid) on the swaptions upon their expiration. Taxpayer asserts that immediate deduction of the loss would clearly reflect income because the protection it obtained with respect to interest rate movements ended on expiration of the swaptions, suggesting that the gain or loss related to the option term of the swaption and not the underlying swap that would have produced benefits had interest rates moved sufficiently upward in the fashion the hedge sought to protect against.

You have indicated that Exam intends to require Taxpayer to take into account the swaption loss (i.e., the premium paid by Taxpayer) over the period of the underlying swaps (three or five years), thereby matching such loss to the interest income earned in the period to which Exam views the hedge to relate.

The hedge timing rules generally require a taxpayer to reasonably match income, deduction, gain or loss on a hedge to the income, deduction, gain or loss on the underlying hedged items. Section 1.446-4(b). Those regulations were generally promulgated to preclude taxpayers from selectively recognizing built-in losses on hedges, which like straddles economically offset other taxpayer positions. In

addressing loss selectivity concerns in the preamble to the Notice of Proposed Rulemaking for the hedge timing rules, the Service stated that, “Although flexibility to control the timing of gain or loss generally is accepted in the tax law, that flexibility is inappropriate when the transaction is so closely related to the asset or liability being hedged.” 1993-2 C.B. 615, 616.

Taxpayer correctly recognizes that premium paid on a swaption is taken into account in measuring any gain or loss realized on the lapse or termination of the swaption or is taken into account as a nonperiodic payment if and when the underlying swap is entered into. Section 1.446-3(g)(3). Here, the two swaptions expired worthless, so – just as with straight options – their lapse caused Taxpayer to have realized losses equal to the premium paid for the swaptions. Rev. Rul. 78-182. The section 1.446-4 hedge timing rules must then be applied; those rules require that the accounting for the hedge income, deduction, gain or loss be reasonably matched with the income, deduction, gain or loss from the hedged item or items. Section 1.446-4(b). (Notably, in its IDR response, Taxpayer did not attempt to address what debt income, deduction, gain or loss the swaption loss was reasonably matched against.)

In this case, the tax accounting match of the swaption loss to the tax accounting of the debt assets is fairly straightforward. Here, Taxpayer’s debt assets were not held for sale and generally would not give rise to tax gain or loss to which the swaption losses could be matched. Moreover, the debt assets did not produce interest expense or other deduction to which the swaption losses could be matched. Thus, the only taxable attribute to which the swaption losses could reasonably be matched is interest income.

The next step in the analysis is to determine exactly what interest income the swaption losses were appropriately matched against. As with plain vanilla interest rate swaps, that analysis requires examining what interest risk the hedge would adjust in the event of adverse interest rate movements. In Rev. Rul. 2002-71, the Service considered how gain or loss on a terminated notional principal contract (a fixed-to-floating swap) used to hedge issued debt should be matched. The swap in that ruling converted the fixed rate payments on the hedged debt into floating rate payments for only the first five years of the debt’s ten year life. The swap period is generally a reliable indicator of the period over which the hedger is seeking to protect against adverse interest rate movements because that is the period for which the cash flows from the swap naturally adjust the interest payments on the hedged debt. Therefore, in Rev. Rul. 2002-71 the gain or loss was related to and accounted for over the swap period. Although not a notional principal contract itself, a swaption is not much different from a swap in terms of its economic use as a hedge. The key distinction is that, unlike a swap, the purchaser of a swaption pays a premium to get the right or option to enter into the swap if rates move in a direction making it advantageous to adjust the terms of the underlying hedged item. But in both the case of a plain vanilla swap and a swaption, their value as a hedge of interest rates is a function of the cash flows that each associated swap might produce. In your situation, the cash flows that Taxpayer could have obtained had rates moved in a direction making the underlying swap

attractive, whether captured early by termination or by entering into the swap, adjusted the yield (effective interest income) of the debt over the life of the swap. (The swaption gave Taxpayer the right to convert the fixed rate debt that it anticipated acquiring into floating rate debt.) Consequently, as in Rev. Rul. 2002-71, the gain or loss from the swaptions should be accounted for over the period of the underlying swaps (three and five years) as that was the period with respect to which Taxpayer was adjusting interest rate risk.

The above analysis is completely consistent with the rules in section 1.446-4(e)(4) that require gain or loss on debt hedges to be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. That regulation generally requires gain or loss from a hedge to be taken into account in the period or periods it would have been taken into account if it adjusted the yield of the debt instrument over the term to which the hedge relates. As indicated above, in the case of swaps, that period is generally the period over which swap cash flows adjust the cash flows and yield of the debt. See Rev. Rul. 2002-71. Consistent with the above, that analysis should not change if the swaps cover a period starting in the future or are contingent on pre-swap period interest rate movements, as are swaptions. Indeed, it would be paradoxical for fundamentally similar hedges to be treated disparately, i.e., swap gain or loss generally being spread over the life of the swap and swaption loss (and perhaps gain) being realized currently (or spread over the remaining option period of the swaption).

Finally, as a policy matter, the section 1.446-4(b) matching rules would succumb to exactly the perceived abuse that they were promulgated to address if Taxpayer's realization method were approved. Taxpayers could freely cherry pick losses by terminating or allowing to lapse swaptions in a loss position but could defer gain by entering into the underlying swap on swaptions that are in-the-money. The potential abuse and harm to the fisc is greatly magnified by the fact that taxpayers would have considerable incentive to enter into offsetting positions because such positions, as hedges, would be excepted from straddle treatment. In short, the loss selectivity and economic straddle concerns make Taxpayer's position unacceptable from a tax policy perspective.

The above should not be read to suggest that other methods might not produce reasonable matching. Section 1.446-4(c). For instance, consistent with section 1.446-4(e)(1)(ii), swaptions used to aggregate hedge debt might be appropriately accounted for on a mark-and-spread basis. That method, however, would still require income, deduction, gain or loss attributable to the realization or periodic marking to market of the hedging transactions to be taken into account over the period for which the hedging transactions are intended to reduce risk. Consequently, use of that method likely produces substantially the same result as Exam's proposal to spread realized swaption losses (as well as gain) over the period of the underlying swap.

Hope the above helps in your ongoing consideration of this matter. Please let me know if any of the above requires clarification or if you desire my participation in any

conversations with Taxpayer aimed at resolving this matter consistent with the hedge matching rules.